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EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

THE AUDITOR'S COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

March 10, 2006

**Prepared by the AICPA Auditing Standards Board for comment from persons interested in
auditing and reporting issues**

**Comments should be received by May 31, 2006, and should be addressed to
Sharon Macey, Audit and Attest Standards,
AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775
or via the Internet to smacey@aicpa.org.**

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March 10, 2006

Accompanying this letter is an exposure draft, approved by the Auditing Standards Board (ASB), of a proposed Statement on Auditing Standards (SAS) entitled *The Auditor's Communication With Those Charged With Governance*. This proposed SAS revises the guidance on communication with those who have responsibility for oversight of the financial reporting process, now referred to as those charged with governance.

A summary of the significant provisions of the proposed SAS accompanies this letter.

Comments or suggestions on any aspect of this exposure draft will be appreciated. To facilitate the ASB's consideration of responses, comments should refer to specific paragraphs and include supporting reasons for each suggestion or comment.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA after June 30, 2006, for one year. Comments should be sent via the Internet to Sharon Macey, Audit and Attest Standards, at smacey@aicpa.org no later than May 31, 2006. Comments may also be mailed to Sharon Macey, Audit and Attest Standards, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775 in time to be received by May 31, 2006.

Sincerely,

John A. Fogarty
Chair
Auditing Standards Board

Charles E. Landes
Vice President
Professional Standards and Services

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The task force gratefully acknowledges the contributions of Diane Hardesty in the development of this proposed Statement on Auditing Standards.

SUMMARY

WHY ISSUED AND WHAT IT DOES

This exposure draft introduces a proposed Statement on Auditing Standards (SAS) that will replace SAS No. 61, *Communication With Audit Committees*, as amended. This proposed SAS establishes standards and provides guidance to an auditor on matters to be communicated with those charged with governance.

In the wake of well-publicized audit failures and emerging best practices in corporate governance, expectations have increased for auditors to communicate openly and candidly with those charged with governance regarding significant findings and issues related to the audit. The Auditing Standards Board (ASB) believes this exposure draft is responsive to the issues and expectations in the U.S. nonissuer community and will improve audit practice and serve the public interest.

In developing this exposure draft, the ASB considered the communication requirements of the Proposed International Standard on Auditing 260 (Revised), *The Auditor's Communication with Those Charged with Governance*, which was issued by the International Auditing and Assurance Standards Board in March 2005.

SAS No. 61 currently establishes communication requirements applicable to entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee. The proposed SAS broadens the applicability of the SAS to audits of the financial statements of all nonissuers and establishes a requirement for the auditor to communicate with those charged with governance certain significant matters related to the audit.

The proposed SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process and internal control over financial reporting. It uses the term *management* to refer to those who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is responsible for preparation of the entity's financial statements.

The proposed SAS identifies specific matters to be communicated, many of which are generally consistent with the existing requirements in SAS No. 61. However, the proposed SAS includes certain additional matters to be communicated and provides additional guidance on the communication process.

In particular, the proposed SAS:

- Describes the principal purposes of communication with those charged with governance and stresses the importance of effective two-way communication.
- Requires the auditor to determine the appropriate person(s) in the entity's governance structure with whom to communicate particular matters. That person may vary depending on the nature of the matter to be communicated.
- Recognizes the diversity in governance structures among entities (including the existence of audit committees or other subgroups charged with governance) and encourages the use of professional judgment in deciding with whom to communicate particular matters.

- Recognizes the unique considerations for communicating with those charged with governance when all of those charged with governance are involved in managing the entity, which may be the case with some small entities.
- Adds requirements to communicate:
 - An overview of the planned scope and timing of the audit.
 - Representations the auditor is requesting from management.
- Provides additional guidance on the communication process, including the forms and timing of communication. Significant findings from the audit must be communicated in writing, while other communications may be oral or in writing,
- Requires the auditor to evaluate the adequacy of the two-way communication between the auditor and those charged with governance.
- Establishes a requirement to document significant matters communicated with those charged with governance.

In addition to the proposed SAS, the exposure draft includes a proposed amendment to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, as amended. The proposed amendment requires the auditor to communicate to those charged with governance events or conditions that cause the auditor to conclude that there is substantial doubt about the entity's ability to continue as a going concern as well as management's plans for addressing such events or conditions.

The comment period for this exposure draft ends on May 31, 2006.

HOW IT AFFECTS EXISTING STANDARDS

This proposed SAS would supersede SAS No. 61, as amended, and amend SAS No. 59. Interpretation No. 1, "Applicability of Section 380," of SAS No. 61 would be withdrawn. Previous references in the auditing standards to an audit committee or those who have responsibility for oversight of the financial reporting process will be replaced by the term *those charged with governance*, where appropriate.

PROPOSED STATEMENT ON AUDITING STANDARDS

THE AUDITOR'S COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

1. This Statement on Auditing Standards (SAS) establishes a requirement for the auditor to determine that certain matters related to an audit of financial statements are communicated to those charged with governance. For purposes of this Statement:

- a. Those charged with governance* means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process, including related internal control over financial reporting. For some entities, those charged with governance may include some or all of management.
- b. Management* means the person(s) responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is responsible for preparing the financial statements, including designing, implementing, and maintaining internal control over financial reporting.

2. This Statement provides a framework for the auditor's communication with those charged with governance and identifies some specific matters to be communicated with them. Additional matters to be communicated are identified in other SASs (see Appendix A). Further matters may also be required to be communicated by agreement with those charged with governance or management, or by additional external requirements.

3. The auditor must communicate with those charged with governance significant matters related to the financial statement audit that are, in the auditor's professional judgment, relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. The communications should be in an appropriate form and on a timely basis. Except for matters that are required to be in writing (see paragraphs 29 and 30), communications may be oral or in writing.

THE ROLE OF COMMUNICATION

4. The principal purposes of communication with those charged with governance are to:
- a. Establish a mutual understanding of the scope and timing of the audit, and of the respective responsibilities of the auditor, those charged with governance, and management in relation to the financial statement audit.*
 - b. Provide those charged with governance with timely observations arising from the audit that are relevant to their responsibilities in overseeing the financial reporting process.*
 - c. Share other information that will assist the auditor and those charged with governance in fulfilling their respective responsibilities.*

5. Communication of specific matters required by this Statement is an integral part of every audit. The auditor is not, however, required to perform procedures specifically to identify other significant matters to communicate with those charged with governance.

6. This Statement focuses primarily on communications from the auditor to those charged with governance. Effective two-way communication between the auditor and those charged with governance is important to understanding matters in context and in developing a constructive working relationship. In doing so, the auditor should be careful to maintain independence and objectivity in this relationship.

7. While the auditor is responsible for communicating matters required by this Statement, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility.

THOSE CHARGED WITH GOVERNANCE

8. The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate.

9. In deciding with whom to communicate matters, the auditor should use professional judgment based on the understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. The appropriate person(s) may vary depending on the matter to be communicated.

10. Governance structures vary by entity, reflecting influences such as size and ownership characteristics. For example:

- In some entities, those charged with governance hold positions that are an integral part of the entity's legal structure, for example, company directors. For other entities, a body that is not part of the entity may be charged with governance, as with some government agencies.
- In some cases, some or all of those charged with governance may be involved in managing the entity. In other cases, those charged with governance and management are different people.

11. In most entities, governance is the collective responsibility of a board of directors, a supervisory board, partners, proprietors, a committee of management, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, such as the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup, such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body as a whole in meeting its responsibilities.

12. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the person(s) within the entity's governance

structure with whom the auditor will communicate. Examples include entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government agencies. When the entity being audited is a component¹ of a group,² the appropriate person(s) with whom to communicate is dependent on the nature of the matter to be communicated and the terms of the engagement.

COMMUNICATION WITH THE AUDIT COMMITTEE OR OTHER SUBGROUP OF THOSE CHARGED WITH GOVERNANCE

13. Audit committees (or similar subgroups with different names) exist in many entities. While their specific authority and functions may differ, communication with the audit committee, where one exists, is a key element in the auditor's communication with those charged with governance. Good governance principles suggest that:

- The auditor has access to the audit committee as necessary.
- The chair of the audit committee and, when relevant, the other members of the audit committee, meet with the auditor periodically.
- The audit committee meets with the auditor without management present at least annually.

14. The auditor should consider whether communication with a subgroup of those charged with governance, such as the audit committee or an individual, adequately fulfills the auditor's responsibility to communicate with those charged with governance. When considering communicating with a subgroup of those charged with governance, the auditor should take into account such matters as:

- The respective responsibilities of the subgroup and the governing body as a whole.
- The nature of the matter to be communicated.
- Relevant legal or regulatory requirements.
- Whether the subgroup (a) has the authority to take action in relation to the information communicated and (b) can provide further information and explanations the auditor may need.
- Whether the auditor is aware of potential conflicts of interest between the subgroup and other members of the governing body.

¹ *Component* means a head office, parent, division, branch, subsidiary, joint venture, associated company, equity investee, or other entity whose financial information is or should be included in the financial statements of a group.

² *Group* means an entity whose financial statements include or should include financial information of more than one component.

- Whether there is also a need to communicate the information, in full or in summary form, to the governing body as a whole. This decision may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body as a whole. The auditor retains the right to communicate with the governing body as a whole, a fact the auditor may make explicit in the terms of the engagement.

COMMUNICATION WITH MANAGEMENT

15. Before communicating matters with those charged with governance, the auditor should consider discussing them with management unless it is inappropriate to do so. For example, it may not be appropriate to discuss with management questions of management's competence or integrity. In addition to recognizing management's responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance.

When All of Those Charged With Governance Are Involved in Managing the Entity

16. In some cases, all of those charged with governance are involved in managing the entity. In these cases:

- a. If matters required by this statement are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role; and
- b. If matters that are required to be communicated are relevant only to the oversight function of those charged with governance (see paragraph 30), no action on the part of the auditor is necessary because there is no oversight separate from management.

17. In such cases, the auditor should consider whether communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. For example, in a company where all of those charged with governance are family members involved in managing the entity, the person responsible for marketing may be unaware of significant findings or issues discussed with the person responsible for the preparation of the financial statements.

MATTERS TO BE COMMUNICATED

18. The auditor should communicate with those charged with governance:

- a. The auditor's responsibilities under generally accepted auditing standards (see paragraphs 21-24);
- b. The planned scope and timing of the audit (see paragraphs 25-28); and
- c. Significant findings from the audit (see paragraphs 29-38).

19. Management's communication of these matters to those charged with governance does not relieve the auditor of the responsibility to also communicate them. Communication of these matters by management may, however, affect the form or timing of the auditor's communication. For example, a summary of the matter communicated may be sufficient when the matter has been communicated appropriately by management.

20. Nothing precludes the auditor from communicating other matters of which the auditor is aware, that in the auditor's professional judgment, are significant to the responsibilities of those charged with governance.

The Auditor's Responsibilities Under Generally Accepted Auditing Standards

21. The auditor should communicate with those charged with governance the responsibilities of the auditor under generally accepted auditing standards. This is often included in the engagement letter or other form of contract that records the terms of the engagement.

22. The auditor should communicate with those charged with governance that the auditor is responsible for:

- a. Performing the audit in accordance with generally accepted auditing standards.
- b. Forming and expressing an opinion about whether the financial statements that have been prepared by management with the oversight of those charged with governance are presented fairly, in all material respects, in conformity with generally accepted accounting principles.
- c. Communicating significant matters related to the financial statement audit that are, in the auditor's professional judgment, relevant to the responsibilities of those charged with governance in overseeing the financial reporting process.

23. The auditor should also communicate that:

- a. An audit conducted in accordance with generally accepted auditing standards is designed to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement; and
- b. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

24. SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, establishes the auditor's responsibility for information prepared by management that accompanies the audited financial statements.³ The auditor should communicate with those charged with governance the auditor's responsibility for other information in documents

³ Guidance on the auditor's consideration of other information is also provided by Statement on Auditing Standards (SAS) No. 52, *Required Supplementary Information*, and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*.

containing audited financial statements, any procedures performed, and whether there were any material misstatements of fact or material inconsistencies in that information.

Planned Scope and Timing of the Audit

25. The auditor should communicate with those charged with governance an overview of the planned scope and timing of the audit. However, the auditor should be careful not to compromise the effectiveness of the audit when communicating with those charged with governance about the scope and timing of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures could reduce the effectiveness of those procedures by making them too predictable.

26. Matters communicated may include the following:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.
- The auditor's approach to internal control relevant to the audit.
- The concept of materiality in planning and executing the audit, focusing on the factors considered rather than on specific thresholds or amounts.
- Where the entity has an internal audit function, the extent to which the auditor will use the work of internal audit, and how the external and internal auditors can best work together.

27. Other planning matters that the auditor may consider discussing with those charged with governance include:

- The views of those charged with governance about:
 - The appropriate person(s) in the entity's governance structure with whom to communicate.
 - The allocation of responsibilities between those charged with governance and management.
 - The entity's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements.
 - Matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
 - Significant communications with regulators.
 - Other matters those charged with governance believe the auditor should consider in planning and executing the audit of the financial statements.

- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.
- The actions of those charged with governance in response to developments in financial reporting, laws, accounting standards, corporate governance practices, and other related matters.
- The actions of those charged with governance in response to previous communications with the auditor.

28. While communication with those charged with governance may assist the auditor in planning the scope and timing of the audit, it does not change the auditor's sole responsibility to determine the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Significant Findings From the Audit

29. The auditor should communicate in writing with those charged with governance the following matters:

- a. The auditor's views about the qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures (see paragraphs 31 and 32).
- b. Significant difficulties encountered during the audit (see paragraph 33).
- c. Uncorrected misstatements, other than those the auditor believes are trivial, if any (see paragraphs 34 and 35).
- d. Disagreements with management (see paragraph 36).
- e. Other findings or issues, if any, arising from the audit that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their oversight of the financial reporting process.

30. Unless all of those charged with governance are involved in managing the entity, the auditor should also communicate in writing:

- a. Material, corrected misstatements that were brought to the attention of management as a result of audit procedures. The auditor also may communicate other corrected misstatements, such as frequently recurring immaterial misstatements that indicate a particular bias in the preparation of the financial statements.
- b. Representations the auditor is requesting from management. In some cases, the auditor may provide those charged with governance with a copy of management's written representations.

- c. Management's consultations with other accountants (see paragraph 37).
- d. Significant issues discussed or the subject of correspondence with management in connection with the initial or recurring retention of the auditor (see paragraph 38).

Qualitative Aspects of the Entity's Accounting Practices

31. Generally accepted accounting principles provide for the entity to make accounting estimates and judgments about accounting policies and financial statement disclosures. The auditor should communicate in writing with those charged with governance the auditor's views about the qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. In addition to the written communication, an open and constructive dialogue helps those charged with governance understand the auditor's views on both the quality and the acceptability of significant accounting practices adopted by the entity. Appendix B provides guidance on the matters that may be included in this communication.

32. The auditor should explain to those charged with governance why the auditor considers a significant accounting practice not to be appropriate and, when considered necessary, requests that changes be made. If requested changes are not made, the auditor should inform those charged with governance that the auditor will consider the effect of this on the financial statements of the current and future years, and on the auditor's report.

Significant Difficulties Encountered During the Audit

33. The auditor should inform those charged with governance of any serious difficulties encountered in dealing with management related to the performance of the audit. Significant difficulties encountered during the audit may include such matters as significant delays in management providing required information, an unnecessarily brief time within which to complete the audit, extensive unexpected effort required to obtain sufficient appropriate audit evidence, the unavailability of expected evidence, restrictions imposed on the auditors by management, and management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested. In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.

Uncorrected Misstatements

34. In accordance with SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*, when communicating to management the details of misstatements identified in connection with the audit, the auditor should distinguish between known misstatements and likely misstatements. If misstatements other than those that the auditor believes are trivial remain uncorrected, the auditor should communicate them to those charged with governance. Where there are a large number of small uncorrected misstatements, it may aid communication if the auditor provides those charged with governance with a summary noting the number and overall monetary effect of the misstatements, rather than communicating the details of each individual misstatement.

35. The auditor should discuss with those charged with governance management's reasons for, and the implications of, a failure to correct known and likely misstatements, considering

qualitative as well as quantitative considerations, including possible implications in relation to future financial statements.

Disagreements With Management

36. The auditor should discuss with those charged with governance any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the entity's financial statements or the auditor's report. Disagreements with management may occasionally arise over, among other things, the application of accounting principles to the entity's specific transactions and events and the basis for management's judgments about accounting estimates. Disagreements may also arise regarding the scope of the audit, disclosures to be included in the entity's financial statements, and the wording of the auditor's report. For purposes of this Statement, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved.

Management's Consultations With Other Accountants

37. In some cases, management may decide to consult with other accountants about auditing and accounting matters. When the auditor is aware that such consultation has occurred, the auditor should discuss with those charged with governance his or her views about significant matters that were the subject of such consultation.⁴

Significant Issues Discussed or the Subject of Correspondence With Management in Connection With the Initial or Recurring Retention of the Auditor

38. The auditor should communicate with those charged with governance any significant issues that were discussed or were the subject of correspondence with management in connection with the initial or recurring retention of the auditor including, among other matters, any discussions or correspondence regarding the application of accounting principles and auditing standards.

THE COMMUNICATION PROCESS

Establishing a Mutual Understanding

39. Clear communication of the auditor's responsibilities (paragraphs 21-24) and the planned scope and timing of the audit (paragraphs 25-28) are intended to form the basis of a mutual understanding, which in turn helps establish effective two-way communication. How this is established will vary, reflecting such factors as the size and governance structure of the entity and how those charged with governance operate. Difficulty in establishing a mutual understanding may indicate that the two-way communication between the auditor and those charged with governance is not effective (see paragraph 51).

40. Matters that may be discussed in establishing a mutual understanding include:

⁴ Circumstances in which the auditor should be informed of such consultations are described in paragraph 7 of SAS No. 50, *Reports on the Application of Accounting Principles*.

- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are in a better position to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- The form in which communications will be made.
- The person(s) on the audit team and among those charged with governance who will communicate regarding particular matters.
- The auditor's expectation that communication will be two-way, and that those charged with governance will communicate with the auditor matters they consider relevant to the audit. Such matters might include strategic decisions that may significantly affect the nature, timing, and extent of audit procedures; the suspicion or the detection of fraud; or concerns about the integrity or competence of senior management.
- The process for taking action and reporting back on matters communicated by the auditor.
- The process for taking action and reporting back on matters communicated by those charged with governance.

Some of these matters may be addressed in the engagement letter or other form of contract that records the terms of the engagement.

Forms of Communication

41. The auditor should communicate in writing with those charged with governance significant findings from the audit (see paragraphs 29 and 30). This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved. Other communications may be oral or in writing.

42. In addition to the significance of a particular matter, the form of communication (for example, the extent of detail or summarization in the communication, whether to communicate formally or informally, and whether other communications are oral or in writing) may be affected by such factors as:

- Whether management has previously communicated the matter.
- The size, operating structure, control environment, and legal structure of the entity being audited.
- In the case of a special purpose financial statement audit, whether the auditor also audits the entity's general purpose financial statements.
- Legal or regulatory requirements that may require a written communication with those charged with governance.

- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The amount of ongoing contact and dialogue the auditor has with those charged with governance.
- Whether there have been significant changes in the membership of a governing body.

43. When a significant matter is discussed informally with an individual member of those charged with governance, for example, the chair of an audit committee, the auditor may summarize the matter in later formal communications so that the others charged with governance have full and balanced information.

Confidentiality

44. When the auditor communicates in writing, the communication should indicate that it is intended solely for the information and use of those charged with governance and, if appropriate, management and is not intended to be and should not be used by anyone other than these specified parties.

45. In certain circumstances, particularly for governmental entities and not-for-profit organizations, the auditor may have a duty to submit copies of certain reports prepared for those charged with governance to relevant regulatory bodies. Similarly, there may be a requirement that reports will be made public. In such circumstances, application of the preceding paragraph is modified appropriately.

Timing of Communications

46. Communications with those charged with governance should be made on a sufficiently timely basis to enable those charged with governance to take appropriate action.

47. The appropriate timing for communications will vary with the circumstances of the engagement. Considerations include the significance and nature of the matter, and the action expected to be taken by those charged with governance. The auditor may consider communicating:

- Planning matters early in the audit engagement and, for an initial engagement, as part of the terms of the engagement.
- Significant difficulties encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulties, or if the difficulties are likely to lead to a modified opinion.
- Significant findings from the audit that are relevant to the financial statements or the auditor's report, including the auditor's views about the qualitative aspects of the entity's accounting practices, before the financial statements are finalized.

48. Other factors that may be relevant to the timing of communications include:

- The size, operating structure, control environment, and legal structure of the entity being audited.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The time at which the auditor identifies certain matters, for example, the auditor may not identify a noncompliance with a law in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

49. If those charged with governance are unwilling to meet with the auditor on a timely basis, the auditor should consider the adequacy of the communication process and the implications for the auditor's assessment of the control environment.

ADEQUACY OF THE COMMUNICATION PROCESS

50. The auditor should evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor should take appropriate action.

51. As discussed in paragraph 6, effective two-way communication assists the auditor and those charged with governance in understanding matters in context and in developing a constructive working relationship. Further, inadequate two-way communication may indicate an unsatisfactory control environment, which will influence the auditor's assessment of the risks of material misstatements.

52. The auditor need not design specific procedures to support the evaluation required by paragraph 50. Rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Examples of audit evidence about the adequacy of the two-way communication between the auditor and those charged with governance may include:

- The appropriateness and timeliness of actions taken by those charged with governance in response to matters communicated by the auditor.
- The apparent openness of those charged with governance in their communications with the auditor.
- The willingness and capacity of those charged with governance to meet with the auditor without management present.
- The apparent ability of those charged with governance to fully comprehend matters communicated by the auditor, such as the extent to which those charged with governance probe issues and question recommendations made to them.
- Difficulty in establishing with those charged with governance a mutual understanding of the form, timing, and expected general content of communications.

- Where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.

53. If, in the auditor's judgment, the two-way communication between the auditor and those charged with governance is not adequate, the auditor should consider the effect, if any, on his or her assessment of the control environment and risks of material misstatements, and the auditor may discuss the situation with those charged with governance. If the situation cannot be resolved, the auditor should consider:

- Modifying the auditor's opinion on the basis of a scope limitation.
- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (for example, a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (for example, shareholders in a general meeting), or the responsible government agency for certain governmental entities.
- Withdrawing from the engagement.

DOCUMENTATION

54. The auditor should document significant matters communicated with those charged with governance. The audit documentation should include copies of the written communications described in paragraph 41. Where matters relevant to the responsibilities of those charged with governance were communicated orally, the auditor should document the communication by appropriate memoranda or notations in the audit documentation. Where documentation is in the form of minutes prepared by the entity, the auditor should be satisfied that those minutes are an appropriate record of the discussion and should include a copy of them in the audit documentation.

EFFECTIVE DATE

55. This statement is effective for audits of financial statements for periods beginning on or after December 15, 2006.

APPENDIX A

COMMUNICATION REQUIREMENTS IN OTHER STATEMENTS ON AUDITING STANDARDS

A1. Requirements for the auditor to communicate with those charged with governance are included in other Statements on Auditing Standards (SASs). This Statement does not change the requirements in:

- a.* Paragraph 17 of SAS No. 54, *Illegal Acts by Clients*, to communicate with the audit committee or others with equivalent authority and responsibility illegal acts that come to the auditor's attention.
- b.* Paragraph 9 of SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, to communicate with the audit committee or others with equivalent authority and responsibility reportable conditions related to an entity's internal control observed during an audit of financial statements.
- c.* Paragraph 22 of SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, to communicate to management and the audit committee or others with equivalent authority and responsibility when the auditor becomes aware during an audit in accordance with generally accepted auditing standards that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, and that an audit in accordance with generally accepted auditing standards may not satisfy the relevant legal, regulatory, or contractual requirements.
- d.* Paragraph 79 of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, to communicate with those charged with governance fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements. In addition, the auditor should reach an understanding with those charged with governance regarding the nature and extent of communications with those charged with governance about misappropriations perpetrated by lower-level employees.

APPENDIX B

QUALITATIVE ASPECTS OF ACCOUNTING PRACTICES

B1. The communication required by paragraph 29(a), and discussed in paragraphs 31 and 32, may include such matters as the following:

Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, considering the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements. Where acceptable alternative accounting policies exist, the communication could include identification of the financial statement items that are affected by the choice of significant policies as well as information on accounting policies used by similar entities.
- The initial selection of and changes in significant accounting policies, including the application of new accounting pronouncements. The communication could include the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity and the timing of a change in accounting policies in relation to expected new accounting pronouncements.
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).
- The effect of the timing of transactions in relation to the period in which they are recorded.

Accounting Estimates

- For items for which estimates are significant, issues discussed in Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates*, and SAS No. 101, *Auditing Fair Value Measurements and Disclosures*, including, for example:
 - Management's identification of accounting estimates.
 - Management's process for making accounting estimates.
 - Risks of material misstatement.
 - Indicators of possible management bias.
 - Disclosure of estimation uncertainty in the financial statements.

Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (for example, disclosures related to revenue recognition, going concern, subsequent events, and contingency issues).

- The overall neutrality, consistency, and clarity of the disclosures in the financial statements.

Related Matters

- The potential effect on the financial statements of significant risks, exposures, and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- The extent to which the financial statements are affected by unusual transactions, including nonrecurring amounts recognized during the period, and the extent to which such transactions are separately disclosed in the financial statements.
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets. The communication could explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.
- The selective correction of misstatements, for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.

APPENDIX C

AMENDMENT TO “AN ENTITY’S ABILITY TO CONTINUE AS A GOING CONCERN” OF STATEMENT ON AUDITING STANDARDS NO. 59, *THE AUDITOR’S CONSIDERATION OF AN ENTITY’S ABILITY TO CONTINUE AS A GOING CONCERN*, AS AMENDED

C1. This amendment adds a requirement that the auditor communicate to those charged with governance events or conditions that, when considered in the aggregate, indicate there could be substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time. Subsequent paragraphs in Statement on Auditing Standards No. 59 are renumbered accordingly.

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

17. If, after considering identified conditions and events in the aggregate and after considering management’s plans, the auditor concludes that substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time remains, the auditor should communicate with those charged with governance:
- a. The nature of the events or conditions identified.
 - b. Management’s plans.
 - c. The possible effect on the financial statements and the adequacy of related disclosures in the financial statements.
 - d. The effects on the auditor’s report.

